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Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

RE: Request for Information to Assist the Interagency Working Group in Conducting the Study and Formulating Recommendations for the Oversight of Existing and Prospective Carbon Markets (Proposed Rule 75 FR 72816)

Dear Mr. Stawick:

Our public comment is addressed specifically to Question 1, which reads as follows:

> "Section 750 of Dodd-Frank indicates that the goals of regulatory oversight should be to ensure that carbon markets are efficient, secure, and transparent. What other regulatory objectives, if any, should guide the oversight of such markets?"

We would suggest adding an additional regulatory objective along the following lines:

> "Carbon market oversight should help covered entities minimize risk-adjusted environmental compliance cost, thereby benefitting ratepayers and consumers."

A formal acknowledgement of this point can help the CFTC in its decision-making surrounding specific rules and regulations. At certain points, for example, it may be appropriate to ask how a proposed alternative might benefit ratepayers or other consumers. It is important to keep in mind that environmental markets are fundamentally different from other securities markets in that their raison d'être is minimizing the compliance cost of a public policy.

The means of "minimizing risk-adjusted environmental compliance cost" are plentiful. Certainly listed electronic exchange trading is consistent with that objective. Additionally, "print and clear" rules pertaining to blocks and less liquid or structured derivatives are another (as the CFTC is currently considering for swap markets). As reporting requirements evolve into real time "print" requirements (as we have seen in equity markets for many years), the CFTC and registered carbon exchanges will likely utilize algorithmic tools for market oversight, which also help reduce compliance costs by reducing the expense of market oversight.

While all of these things are critically important, our remaining comments are focused exclusively on the topic of allowance accounting by covered entities. Though the CFTC is not directly responsible for accounting, the decisions made in this area will have direct effect on challenges the CFTC might face in establishing and regulating this market. In short, the accounting treatment of carbon instruments (referring to both allowances and allowance derivatives) by covered entities is a critical factor in shaping carbon market structure.

The accounting issue is best framed by considering two extremes – one where covered entities must mark all carbon instruments to market and the other where accounting for carbon instruments parallels that of tangible investments in abatement assets. In the former, carbon will be a dealer market with powerful incentives to create accounting-driven OTC structured products. In the latter, carbon will be a more principal-driven market where covered entities make more direct use of listed instruments. Transparency, volatility, and systemic leverage of the carbon market are thus, to some degree, a function of accounting treatment by covered entities.

Accounting neutrality between carbon instruments and real abatement investments is not easy to achieve and arguably cannot be entirely accomplished. That said, simply leaving OTC transactions between a dealer (who is fine with mark-to-market) and a covered entity (who cannot absorb the income statement volatility of mark-to-market) seems inconsistent with CFTC and Dodd-Frank market objectives.

Accounting neutrality between real abatement assets and financial carbon instruments might be achieved by treating the purchase of carbon instruments as a deferred expense. A simple summation of this approach is as follows:

> Allowance banks, as well as physically-settled futures and options – *to the degree purchased and held to satisfy a future compliance obligation* – would be booked as a deferred expense and held at cost on the balance sheet.

This accounting, in addition to being a reasonably factual portrayal of what is actually occurring, provides a stable means for covered entities to lock in future expenses and risk-manage their compliance obligations. Obviously, if the covered entity's intention changes, or if the carbon instruments are later sold rather than submitted for compliance, then a mark-to-market would occur.

Borrowings could be treated similarly: if allowances are borrowed to be submitted for compliance, a deferred liability would be created and held at cost on the balance sheet – *provided that the intention of the covered entity is to repay the obligation with future over-compliance*.

Deferred expense accounting treatment might benefit the carbon market in a number of ways:

1. Greater use of listed instruments by covered entities
2. Enhanced overall market transparency
3. Lower intermediation costs
4. Over time, more liquidity in long-dated listed derivatives
5. Over time, reduction in margin arbitrage thereby reducing systemic risk

In short, if covered entities can use the allowance and allowance derivative markets to lock-in future compliance expenses, then listed markets will be driven by the covered entities most directly connected to the true costs of abatement. A more efficient market, with less systemic risk and lower policy costs, is likely to ensue.

We would suggest a joint task force of the CFTC, the SEC Accounting Staff, the FASB, EPA, and representatives of various industry groups to evaluate accounting alternatives and their impact on disclosure, the carbon market, and policy costs.

Thank you for the opportunity to comment on this matter.

Respectfully submitted,

Jon Anda